WHEN WILL THE CANARIES ARRIVE?

The emergence of inflation will precede the next commercial real estate downturn.

THE DIFFICULTY OF PREDICTING THE NEXT REAL ESTATE DOWNTURN

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During the 19th century, miners dug deep into the Earth, extracting valuable minerals and deposits that served as the raw materials for the Industrial Revolution. In the process, countless miners lost their lives to odorless, colorless gases such as carbon monoxide.

In response, at the beginning of the 20th century John Scott Haldane, a Scottish physiologist, devised a simple solution to protect these men — the canary cage.[1]

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Haldane is famous, even infamous, for locking himself up with deadly gas in a sealed room and taking copious notes on how it felt to be slowly poisoned.[2] He discovered that small animals like canaries are intensely vulnerable to these gases. The use of these birds offered miners the opportunity to escape before the miners, too, were overcome by carbon monoxide. Canaries in a coal mine represented an early-warning detection system that ended up saving thousands of lives well into the 20th century.

Economists seldom poison themselves. Although they may lack Haldane's commitment, economists also search for something similar to canaries in coal mines called leading indicators, which can warn workers, investors, and others of imminent peril in the market.

At present, there appears to be little poison emanating from the U.S. economy. As of this writing, unemployment is at a 17-year low, consumer confidence is at a 17-year high, corporate profits are elevated, and a legislated federal tax cut promises to supercharge an economy that has already been expanding at 3 percent or better during recent quarters.

Financial markets appear ebullient, with America's multinationals increasingly benefitting from a strengthening global economy. It would appear that the risk of recession in the near-term is small. In fact, a recent survey of economists suggests that the chance of a recession over the next 12 months is just 14 percent.

For those in commercial real estate and construction, this is great news. With the economy gaining momentum, employers are searching for talent and capacity. Currently, there are more than 6 million job openings in America.[3] There are only 1.1 job seekers for every available job opening, implying that America's 4.1 percent unemployment will likely continue to trend lower.[4] In turn, this directly and/or indirectly supports office space absorption, creates demand for warehouse and flex square footage, and produces elevated hotel occupancy. All of this translates into ongoing momentum in a number of key construction segments.

However, there is always reason for concern, with the present period being no exception. Commercial real estate is especially susceptible to vicious cycles of boom and bust for a number of reasons, including the relatively illiquid nature of market assets. During a downturn, it can be difficult to find buyers, particularly for underperforming real estate. The result can be cascading decreases in value, leading to sharp losses and additional illiquidity.

Moreover, during cyclical peaks, developer and financier confidence reach an apex. This translates into a significant amount of construction toward the end of growth cycles. It is often the case that a substantial number of properties become operational even as the economy is shrinking and demand for space/units falls. Such was the case in 1990, 2001, 2008, and similar years.

The upshot is that identifying market peaks can be of enormous value to individual investors and to the broader economy. If investors are able to predict a coming recession, this will produce less supply and ultimately a shorter, less damaging downturn. Theoretically, if leading indicators are highly reliable, downturns can be avoided altogether, with various markets perpetually remaining in equilibrium.

Analysts monitor a number of economic variables neatly tied to shifts in the level of activity taking place in commercial real estate markets. Some of these indicators are obvious, such as employment. As long as employment is growing (particularly in financial services, as it turns out), demand for space will generally be on the rise.

However, employment is not really a leading indicator, at least not from a broader economic perspective. Employment is generally considered a lagging indicator, with the notion being that job openings arise after a prior uptick in economic activity that induces employers to bulk up their staffing models. In other words, employment often follows gross domestic product (GDP), which is viewed as a coincident indicator (an indication of how the economy is performing presently). For instance, after the most recent downturn, GDP began to turn higher during the third quarter of 2009, but employment didn't attain its cyclical nadir until October 2010.

As it turns out, the search for leading indicators leads to exotic territory. A National Association for Industrial and Office Parks (NAIOP) analysis determined that change in the money stock as measured by M2 "appears to have a remarkably similar cycle to that of real estate completions." However, the analysis goes on to indicate that "money stock appears to be more in step with commercial property completions than commercial starts…it appears that change in money stock may not be a leading indicator of development, but a coincident indicator of commercial stock growth."[5]

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The implication here is that one needs to predict changes in monetary policy, which in turn helps determine money supply. Monetary policy, of course, responds to a variety of factors, perhaps none more important than inflation. Indications of rising inflation and inflationary expectations imply that America's central bank, the Federal Reserve, will tighten monetary policy, thereby slowing growth in M2.

The bottom line, therefore, is that the emergence of inflation will precede the next commercial real estate downturn, perhaps by four to eight quarters or a bit more. With the nation approaching full employment and capacity utilization on the rise, investors, developers, bankers, contractors, realtors, and other stakeholders should be intensely focused on a variety of inflation measures — including the core personal consumption expenditures deflator and various producer price and consumer indices — to help peer into the future. ■

NOTES

[1] Eschner, K., The Story of the Real Canary in the Coal Mine, *Smithsonian.com* (Dec 30, 2016). Available at: https://www.smithsonianmag.com/smart-news/story-real-canary-coal-mine-180961570/.

[2] Inglis-Arkell, E., Why did they put canaries in coal mines? *Gizmodo* (Jan 1, 2014). Available at: https://io9.gizmodo.com/why-did-they-put-canaries-in-coal-mines-1506887813.

[3] "Job Openings and Labor Turnover Summary," U.S. Bureau of Labor Statistics (2018). Available at: https://www.bls.gov/news.release/jolts.nr0.htm.

[4] "Employment Situation Summary,". U.S. Bureau of Labor Statistics (2018). Available at: https://www.bls.gov/news.release/empsit.nr0.htm.

[5] Mueller, A.G. and Mueller, G.R., National and Metro Predictors of Commercial Real Estate Development, *NAIOP Research Foundation* (Jan 2009).